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IN THE

SUPREME COURT

OF THE

UNITED STATES.

October Term, 1937

No. 405

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner,

vs.

THOMAS A. O'DONNELL,

Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF FOR THE RESPONDENT.

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On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF FOR THE RESPONDENT.

Opinions Below.

The opinion of the Board of Tax Appeals [R. 47-52] is reported in 32 B. T. A. 1277, the opinion of the Circuit Court of Appeals [R. 85-90] in 90 F. (2d) 907.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered June 14, 1937 [R. 90]. Petition for writ of certiorari was filed September 11, 1937, and granted by order filed October 25, 1937. The jurisdiction of this court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

Is a taxpayer, having a right to share in the proceeds of oil production, to be denied depletion merely because his share of such proceeds is measured by the net profits rather than gross receipts from production?

Statutes Involved.

Set forth in the appendix, *infra,* pp. 19, 20.

Statement of the Case.

The respondent, Thomas A. O'Donnell, an oil operator, owned one-third of the capital stock of the San Gabriel Petroleum Company. He sold the aforesaid stock to the Petroleum Midway Company, Ltd. by written contract of January 9, 1918 [R. 44]. The contract is on file with the stipulation of facts as Exhibit "A" [R. 77-80]. The contract provided that the purchaser, as owner of all of the stock of San Gabriel Petroleum Company, would acquire all of its assets and then dissolve it [R. 44]. The contract further provided that:

> "Second party agrees to purchase, and does hereby purchase, all of said first party's stockholdings in said San Gabriel Petroleum Company, and agrees to pay therefor, at the times and in the manner hereinafter specified, one-third (⅓) of the net profits received by it, its successors or assigns, from the development and operation of the properties described and enumerated in the leases, contracts and agreements now owned by said San Gabriel Petroleum Company, for and during the full, unexpired term or terms of said leases, contracts and agreements, and each of them." [R. 44.]

Petroleum Midway Company, Ltd. agreed to furnish all money necessary for development and operation, to comply with all the terms and conditions of the various leases, contracts and agreements, and to do and perform each and all such acts and things as might be necessary to protect said leases, contracts and agreements from cancellation or forfeiture [R. 79].

In accordance with the contract Petroleum Midway Company, Ltd. (name since changed to California Petroleum Corporation of California) acquired all of the assets of San Gabriel Petroleum Company and dissolved it, and developed and operated the oil properties thus acquired and paid respondent one-third of the net profits so received from the date of contract to August 4, 1926 [R. 44-45]. Respondent received $50,270.02 in 1925 and $12,842.48 in 1926. (Subsequent payments were made to Mrs. O'Donnell, which the court below held were taxable to her.)

The assets taken over by the Petroleum Midway Company, Ltd. consisted of oil and gas leases, and all payments to respondent, and his wife thereafter, were made from profits derived from the sale of oil, gas and other hydrocarbon substances produced from the properties covered by the leases [R. 76].

The petitioner erroneously refused to allow the respondent a deduction for depletion sustained with respect to such payments so made entirely from profits derived from the sale of oil, gas and other hydrocarbon substances produced only from the properties covered by the leases.

The Board of Tax Appeals reversed the petitioner's determination and allowed the claimed depletion. The Circuit Court of Appeals affirmed the Board.

LAW AND ARGUMENT.

Respondent Is Entitled to a Depletion Deduction With Respect to Income Received by Him in 1925 and 1926 Pursuant to the Contract With Petroleum Midway Company, Ltd.

Petitioner employs a more or less ingenious type of dissembling argument reminiscent of that caustically referred to in *Lynch v. Alworth Stephens Co.*, 267 U. S. 364, wherein this Honorable Court aptly stated that:

> "* * * the reasonable allowance for depletion in case of a mine is to be made to everyone whose property right and interest therein have been depleted by the extraction and disposition of the product thereof * * * And the plain, obvious, and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover.".

The government in that case ingeniously argued that the depletion allowance applied to the physical exhaustion of the ore deposit, and since the title thereto admittedly was retained by the lessor, his property only was depleted by extraction of ore and he alone was entitled to the depletion allowance. This Court held that regardless of technical ownership of the ore in place the taxpayer by his lease had acquired a very real and substantial interest in the unextracted ore deposits, that such was property and had been depleted.

In *Palmer v. Bender*, 287 U. S. 551, taxpayer assigned certain leases in partial consideration of the sum of $1,000,000.00 payable out of proceeds derived from the sale of one-half the first oil produced and saved. Petitioner

claims the instant case to be unlike *Palmer v. Bender* in that respondent here must necessarily have acquired rather than retained an economic interest; not only suggests that deduction of operating costs and 6% interest on advances made by the operating oil company in determining net profits derived from development and operation of the oil properties affected by the agreement of January 9, 1918 [R. 77-80], renders *Palmer v. Bender* and collateral cases inapplicable, but erroneously insists throughout his brief that taxpayer in *Palmer v. Bender* actually shared in kind in oil produced. Furthermore, petitioner has ingeniously devised innumerable technicalities to obscure and avoid the effect of basic apportionment principles enunciated and reiterated by this Honorable Court, yet studiously avoids quoting the material portion of this Honorable Court's opinion in *Palmer v. Bender,* pp. 556-7, which reads as follows:

> "* * * It will be observed that the statute directs that reasonable allowance for depletion be made as a deduction in computing net taxable income, 'in the case of oil and gas wells, . . . according to the peculiar conditions in each case.' The allowance to the taxpayer is not restricted by the words of the statute to cases of any particular class or to any special form of legal interest in the oil well. It is true that under Article 215 of Treasury Regulations 62 the lessor of an oil or gas well is entitled to a depletion allowance upon the bonus and royalties received from the lessee. See *Murphy Oil Co. v. Burnet,* 287 U. S. 299, *ante,* 318, 53 S. Ct. 161, *supra.* But there is nothing in the statute or regulations which confines depletion allowances to those who are technically lessors. The concluding sentence of the section that 'In the case of leases the deductions al-

lowed by this paragraph shall be equitably apportioned between the lessor and the lessee' presupposes that the deductions may be allowed in other cases. The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital.

"That the allowance for depletion is not made dependent upon the particular legal form of the taxpayer's interest in the property to be depleted was recognized by this Court in *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 69 L. ed. 660, 45 S. Ct. 274. * * *"

"Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough, if by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production. * * *"

This Court, commenting upon the elaborate argument presented by opposing counsel in *Palmer v. Bender*, 287 U. S. 551, with respect to the formal attributes of the instruments there involved, expressly held immaterial artificial technicalities affecting the title to property. Likewise, in the quoted portion of the opinion it will be noted that the allowance for depletion is not made dependent upon respondent having acquired or retained ownership of, or any other particular form of legal interest in, the mineral content of the land. On the contrary, it is re-

quired that the depletion allowance shall be equitably apportioned to every taxpayer who has acquired by investment any interest in the oil in place, and secured by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital. The interest referred to is the so-called economic interest, the existence of which, consequently, is independent of respondent having acquired or retained ownership of, or any other particular form of legal interest in, the mineral content of the land. An economic interest is in fact defined as a right to share in the oil produced, customarily evidenced by the right to receive a share of income derived from the sale of oil produced. Petitioner would require actual receipt of oil in kind. The identical authorities petitioner cites on brief negative his argument, which should no longer require a citation of adverse authority. Receipt of oil in kind is clearly not required, merely receipt of income derived from the extraction of oil, a share in the proceeds of oil produced.

Palmer v. Bender, 287 U. S. 551;

Helvering v. Twin Bell Syndicate, 293 U. S. 312;

Burnet v. Harmel, 287 U. S. 103;

U. S. v. Noble, 237 U. S. 73, 74, 59 L. ed. 844.

In the last cited case this Honorable Court stated:

> "* * * It is said that the leases contemplated the payment of sums of money, equal to the agreed percentage of the market value of the minerals, and thus that the assignment was of these moneys; but the fact that rent is to be paid in money *does not make it any the less a profit issuing out of the land* * * *." (Italics supplied.)

The mere fact that under the contract Midway paid respondent cash instead of oil does not in any wise change the nature of respondent's interest.

Respondent acquired by investment a very real and substantial economic interest, a right to share in the proceeds of oil produced and has in fact secured income derived entirely from the extraction of oil, to which he certainly must look for a return of his capital. An analysis of the following facts will compel the conclusion that respondent acquired something by investment, clearly a property right identical with that formerly possessed by San Gabriel Petroleum Company, which was a depletable property right.

The contract of January 9, 1918 [R. 77-80] provided, and the lower court so found, that Petroleum Midway Company, Ltd., agreed to and did pay respondent one-third of the net profits derived from the development and operation of the oil properties described and enumerated in the oil leases, for and during the unexpired term or terms thereof. Midway merely had the right to operate the property, produce the oil, and before dividing the proceeds derived therefrom, to deduct stipulated interest and expense.

Receipt of income was definitely measured by and contingent entirely upon production of oil, payable only out of oil, if, as, and when produced, and to that extent. Income would cease upon exhaustion of the mineral content or prior expiration of the lease terms, as respondent

was not entitled to income derived by Midway from other oil properties or from any other source whatsoever, but only to the net proceeds of oil if, as, and when produced from these particular properties. Petitioner stipulated [R. 76] to that effect.

Respondent must necessarily look to the oil content for a return of his capital. If petitioner were to strain his ingenuity to the utmost, it could scarcely be contended otherwise, for the oil content of these particular properties is obviously the sole possible source of income to respondent under the contract, and consequently the sole possible source of capital return. It must be admitted that, if not returned through the depletion allowance, respondent's capital will certainly be lost upon total exhaustion of the mineral content or prior expiration of the lease terms. Progressive exhaustion of the mineral content certainly depletes respondent's reservoir of capital to that extent.

Petitioner vigorously contends that receipt of net rather than gross proceeds is fatal to the depletion allowance and that gross income means gross receipts from the oil extracted. Petitioner erroneously insists throughout his brief that gross income is synonymous with gross receipts. The distinction is obvious. Percentage depletion is based on gross income and not gross receipts. The statute refers to the *taxpayer's* gross income. Both respondent and Midway are taxpayers and each has gross income. The amount received by respondent was his gross income and it is that gross income which the statute refers to in determining the amount of the depletion deduction. Neither Midway nor respondent could take a depletion deduction based on a percentage of gross receipts. Midway, in computing its gross income from the property for the pur-

pose of determining its allowance for depletion, was required by Section 204 (c) (2) of the Revenue Act of 1926 to deduct from gross receipts, and thus exclude from gross income, an amount equal to rents and royalties paid or incurred in respect of the property.

Greensboro Gas Co. v. Commissioner, 30 B. T. A. 1362, 79 F. (2d) 701, Certiorari denied 296 U. S. 639;

Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312.

It could scarcely be contended that payments made to respondent were not paid or incurred by Midway in respect of the property. In harmony with that requirement, and for the same basic reason, Congress further provided that the total allowable depletion deduction should be equitably apportioned. Midway as a result ultimately deducted only 66-⅔% of the total allowable depletion. One hundred per cent (100%) of oil produced admittedly depleted the oil content. Someone is entitled to the remainder, obviously, the respondent. The amount he received was his gross income from the property and it is that gross income to which the statute refers.

As a matter of fact, net proceeds merely measured the relative amount respondent received; the deductions merely diminished respondent's economic interest, did not alter its character as such. On the contrary, it would seem indicative of, and entirely consistent with an economic interest that one should bear a pro rata share of operating expense. Respondent might have obtained a one-fourth or greater share of the gross proceeds derived from the sale

of oil and petitioner would probably concede the economic interest and depletion allowance. Yet, although the economic interest remains intact merely because respondent chose to accept one-third and bear his pro rata share of expense, petitioner would deny the existence of the interest.

The position taken by the petitioner in this case is inconsistent with his long continued practice in respect of cases which involve so-called working agreements which are common in the oil industry. These working agreements always have as one party thereto (usually called the first party), a lessee of an oil property and usually have as the second party an operating oil company sufficiently well supplied with capital to develop and operate the lease in question. Under the terms of such an agreement the first party will assign to the second party all of his right, title and interest in and to the lease in consideration of the agreement of the second party to furnish the necessary capital to drill wells and if oil is discovered to operate them and to pay to the first party a fraction of the net receipts derived from the oil produced, saved and sold after the second party has recovered all of his cash outlay in connection with the development and operation of the lease. In such a case, as in the case at bar, the first party's right is the same as respondent's right, namely, the right to share in the net proceeds derived from the production of oil from the property in question. In the cases of the working agreements the petitioner (since this Honorable Court's decision in *Palmer v. Bender*, 287 U. S. 551) has permitted and does now permit the first party, who has only the right to share in net proceeds derived from the sale of oil, a deduction for depletion in an amount equal to 27½% of his interest in the gross income derived from the sale of oil limited to 50% of the net income.

As an illustration: Suppose the situation under a working agreement wherein the assignor, first party of the lease, is entitled to 50% of the net proceeds derived from the production of oil after the assignee recovers his capital; assume that in a given taxable year the gross income, less landowner's royalty, amounts to $100,000.00 and that the net income from the property before allowance for depletion amounts to $50,000.00. The Respondent would allow the first party to the working agreement depletion in the amount of $12,500.00, being in this case one-half of the net income.

Now, the interest which the assignor in a working agreement has in the oil property is merely the right to share in the net proceeds derived from the production of oil; he has no right to demand oil in kind nor does he share in any percentage of the gross proceeds derived from the sale of oil. He simply shares in the net proceeds just the same as respondent does here, but, of course, he does share, like the respondent, in profit flowing from the oil.

This is not a criticism of the petitioner's treatment of depletion in such cases because it seems fair and reasonable that the assignor under a working agreement should be entitled to depletion computed as the petitioner computes it in such cases.

Respondent has not in this case contended that he was entitled to depletion computed upon the basis of one-third of the gross income from the property limited to one-half of one-third of the net income. It would seem, however, that it would be just as logical that he be allowed depletion computed upon that basis as it would be to allow the assignor under a working agreement that depletion. In any event, the Petroleum Midway Company should not be allowed depletion upon that portion of its gross income

payable to the respondent and such an allowance to it violates the requirement that depletion should be apportioned between lessor and lessee.

Petitioner on pages 13 and 14 of his brief for the first time contends that a former case (*Thomas A. O'Donnell v. Commissioner,* 25 B. T. A. 956-963; 64 F. (2d) 634, Certiorari denied 290 U. S. 699) determined that O'Donnell had recouped his entire cost prior to 1923. Petitioner however fails to paint the true picture presented in that case. On the day the case was tried before the Board of Tax Appeals the Commissioner filed a second amended answer wherein he for the first time affirmatively alleged that O'Donnell derived taxable income to the extent of $114,908.31 on account of the receipt by the trustees of revocable trusts of this amount which was derived from the Petroleum Midway Company, Ltd. under and pursuant to the contract of January 9, 1918. Mr. O'Donnell had assigned to the trustees under the revocable trusts the contract of January 9, 1918 [transcript of record pages 25, 40, 54, 95, Supreme Court of the United States, October Term 1933, *Thomas A. O'Donnell v. Commissioner.*] The Board of Tax Appeals held that the income derived by the trustees during 1923 under the revocable trusts, pursuant to the contract of January 9, 1918, constituted taxable income to Mr. O'Donnell, and incidentally held that such income exceeded any possible recoupment of capital to which Mr. O'Donnell might have been entitled. Mr. O'Donnell did not recoup his cost. Nowhere does it appear that the Commissioner allowed a return of capital in previous years, or that Mr. O'Donnell sought such allowance. Incidentally, the Circuit Court of Appeals in that case referred to "the royalty interest he (O'Donnell) retained in the income derived from the oil property."

Mr. O'Donnell in the former case contended that the Board of Tax Appeal's findings of fact and opinion were based on issues not raised by the pleadings and contended that if the income was taxable to Mr. O'Donnell (since it was derived as a royalty from oil property) the case should be remanded for further proceedings to determine the depletion allowance on the proceeds derived from mineral properties. (Brief in support of petition for writ of certiorari to this Court, *O'Donnell v. Commissioner*, p. 17.) Mr. O'Donnell felt that a grievous injustice had been done him in the denial of his petition to have the case remanded to determine the depletion on this income from oil properties. This Honorable Court's denial of O'Donnell's petition for certiorari was entered prior to the decision of this Honorable Court in *Guy T. Helvering, Commissioner of Internal Revenue v. Gowran*, decided December 6, 1937, wherein this Court remanded that case to the Board to determine a new issue.

A reference to the former case of O'Donnell and particularly the Board's findings of fact (*Thomas A. O'Donnell v. Commissioner*, 25 B. T. A. 956-963) shows that in March, 1917, Mr. O'Donnell, M. L. and L. A. McCray for a nominal consideration, secured five development oil leases and that in June, 1917, they transferred these leases to a corporation organized by themselves—the San Gabriel Petroleum Company—for all of its capital stock, each receiving one-third thereof and that thereafter Mr. O'Donnell acquired all the stock owned by the two McCrays. This record also shows that these same leases in which Mr.

O'Donnell had an interest prior to the organization of the San Gabriel Petroleum Company were transferred to the Petroleum Midway Company, Ltd. under and pursuant to the contract of January 9, 1918. It, therefore, follows that Mr. O'Donnell originally acquired an interest in the leases and does now have an interest therein, at least to the extent of sharing in the proceeds derived from production. When the record in that case is considered (as counsel for the petitioner assumes it should be) it is seen that Mr. O'Donnell had and does now have a very direct interest in the leases and the oil properties covered thereby. Mr. O'Donnell's interest in the leases and the oil properties covered thereby eloquently explains the reasons why the following provision was incorporated in the contract of January 9, 1918 [R. 79]:

> "Second party further agrees to comply with all the terms and conditions of the various leases, contracts and agreements now owned by said San Gabriel Petroleum Company, and to do and perform each and all such acts and things as may be necessary to protect said leases, contracts and agreements from cancellation or forfeiture."

Of course, Mr. O'Donnell, having an interest in the leases themselves with the consequent obligations of performance, was naturally desirous of protecting himself against the cancellation or forfeiture of these leases, and was also anxious that he not run any risk on account of the failure of the Petroleum Midway Company to fully comply with the provisions of the leases. The facts, therefore, demonstrate that Mr. O'Donnell at all times has had

and does now have a direct interest in the leases and in the oil properties which interest certainly entitles him to depletion under the specific provisions of the Revenue Act. The defense that O'Donnell made in the prior case certainly is not sufficient to deny him the right which the law specifically gives.

The case of *Commissioner v. Elliott Petroleum Corp.*, 82 F. (2d) 193, is sufficient authority that the defense made by Mr. O'Donnell in the prior case would not be binding or have any effect in the case at bar.

Conclusion.

The decision of the Board of Tax Appeals and of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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APPENDIX.

Revenue Act of 1926, c. 27, 44 Stat. 916:

SEC. 204. * * *.

(c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * * * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½% per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 214 (a) In computing net income there shall be allowed as deductions:

* * * * * * * * *

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

* * * * * * * * *

Revenue Act of 1928, c. 852, 45 Stat. 799:

SEC. 23. * * *

(1) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion in case of oil and gas wells, see section 114 (b) (3).)

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Petitioner,

vs.

THOMAS A. O'DONNELL,

Respondent.

PETITION FOR REHEARING AND MOTION TO STAY ISSUANCE OF MANDATE.

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GUY T. HELVERING, Commissioner of Internal Revenue,

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vs.

THOMAS A. O'DONNELL,

Respondent.

PETITION FOR REHEARING.

Comes now Thomas A. O'Donnell by his attorneys, Thomas R. Dempsey and A. Calder Mackay, and presents this his petition for a rehearing of the above entitled cause (judgment having been entered on March 7, 1938) under Rule 33 of the Revised Rules of the Supreme Court of the United States, and in support thereof respectfully urges:

THAT THE DECISION OF THIS HONORABLE COURT IS CONTRARY TO THE DECISIONS OF THE SUPREME COURT OF THE STATE OF CALIFORNIA DETERMINING PROPERTY RIGHTS AND THAT, THEREFORE, THE DECISION OF THIS HONORABLE COURT IS CONTRARY TO THE DECISIONS RENDERED BY THIS COURT IN THE CASES OF FREULER V. HELVERING, 291 U. S. 35, 54 Sup. Ct. 308, 13 A. F. T. R. 834, AND SHARP, EXECUTORS, V. COMMISSIONER OF INTERNAL REVENUE, SUPREME COURT OF THE UNITED STATES,